Bulletin

2013-01B

BOND PREMIUMS AND DEBT EXCLUSIONS

(Supersedes Bulletins 2003-11B and 20B and Inconsistent Prior Written Statements)

TO: Assessors, Collectors, Municipal/Regional School Treasurers, Accountants/Auditors, Mayors/Selectmen, City/Town Managers/Executive Secretaries, Finance Committees, Finance Directors, City Solicitors/Town Counsels, Clerks and Regional School Superintendents

FROM: Gerard D. Perry, Director of Accounts

DATE: March 2013

SUBJECT: Impact of Bond Premiums on Borrowings Subject to Debt Exclusions

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This *Bulletin* explains the application of premiums received in connection with the sale of bonds or notes that are subject to an approved Proposition 2½ debt exclusion generally and announces an alternative method for applying them. G.L. c. 59, § 21C(k). It supersedes *Bulletins* 2003-11B (May 2003) and 2003-20B (October 2003) and any inconsistent prior written statements and is effective immediately.

If you have any questions, please contact the Public Finance Section of the Bureau of Accounts at 617-626-2382.

A. TREATMENT OF PREMIUMS

Premiums received when bonds or notes are sold, less issuance costs, are general revenue of the city, town or district and cannot be spent without appropriation. G.L. c. 44, §§ 20 and 53.

A premium received for a bond or note for which a Proposition 2½ debt exclusion has been approved ("excluded debt"), must be offset against the stated interest cost of financing the project when computing the annual exclusions for the borrowing. G.L. c. 44, § 20. This ensures that the additional amount raised in taxes for the borrowing reflects the true interest cost of financing the project.

B. TRUE INTEREST COST ADJUSTMENT

Form DE-1 is used as part of the tax rate process to document and report the amount to be added to the levy limit for approved debt exclusions. This section explains the method for determining, in Fiscal Year 2005 and later years, the adjustment required in the reported debt exclusion on account of a premium in order to reflect the true interest cost.

1. Bond Issue

Form DE-1 for a bond issue is completed as follows. The example shown uses the attached debt service schedule for a bond issue dated 11/15/02 for $18,138,000.

Column G: Debt service (principal and interest) for the current fiscal year
Column H: Adjustments for School Building Authority or other reimbursements
Applicable portion of premium, computed as follows:

Premium received at time of sale, less cost of issuance *if paid from premium*

- divided by total interest payable over life of bond or note
- equals a percentage of interest costs
- multiplied by the interest included in Column G for current year

Debt service schedule (applicable portion):

FY	Due Date	Principal	Interest	Total
2005	11/15/04		$397,782.50	
	05/15/05	$605,000.00	$397,782.50	$1,400,565.00
TOTAL		18,138,000.00	10,469,020.00	$28,607,920.00

Closing details:

Premium	$811,599.72
Less: Underwriting	- 70,947.64
Less: Bond Insurance	- 90,690.00
Net Premium	$649,962.08

Calculation of premium as percentage of interest cost:

Net Premium	$649,962.08
Divided by interest cost of life of issue:	$10,469,020.00
Premium as % of Interest	= 6.2%

Calculation of adjustment of interest for debt exclusion

FY	Annual Interest Due	x Premium %	Adjustment
2005	$795,565.00 ($397,782.50 x 2)	x 6.2	$49,325
Subsequent, *e.g.*, 2006	$783,162.50 ($391,581.25 x 2)	x 6.2	$48,558

2. Note Issue

Bond anticipation note (BAN) issues are generally for a term of one year with interest payable at maturity. The DE-1 for a one year BAN is completed as follows:

Column G: Debt service -- interest for the current fiscal year
Column H: Adjustments -- premium received, less cost of issuance *if paid from premium*

For a two year BAN with interest payable semiannually, the premium adjustment would be proportional to the interest payments occurring in each fiscal year.

3. Accounting Procedures

The premium is reserved for appropriation to offset debt service budgeted in future years for the project, rather than closed to unreserved fund balance at the end of the fiscal year received. This ensures the interest payment due will be fully offset by the addition to the tax levy for the debt exclusion in those years.

4. Investment

Treasurers should consult with bond counsel to ensure that the investment of the premium reserved for appropriation in future years is consistent with federal arbitrage regulations on tax-exempt borrowings.

5. Regional School District Debt Excluded by Member Cities or Towns

Regional school district debt for a project that has been excluded by a city or town is subject to these same procedures. The assessment to the city or town should reflect only the net interest cost associated with the project.

C. ALTERNATIVE APPLICATION OF PREMIUMS TO PROJECT COSTS

The adjustment explained in Section B above is not required to the debt exclusion for a borrowing if the premiums received in connection with the sale of the bonds or notes are appropriated to reduce project costs and the amount borrowed as explained in Sections C-1 and C-2 below. The full amount of the debt service payable in each year is excluded and reported on the DE-1.

This alternative is available to cities and towns with debt exclusions for municipal borrowings and regional school districts for district borrowings for which all members have approved debt exclusions.

1. <u>Premium Received</u>

Cities, towns and regional school districts that receive a premium on excluded debt for a project that has <u>not</u> been permanently financed may appropriate the premium (less issuance costs if paid from the premium) to (1) pay project costs directly or (2) pay-down BANS for the project. To do so, however, they must, at the time of the appropriation, also vote to rescind the same amount of the authorized borrowing for the project. This alternative approach results in the issuance of fewer bonds or notes and the avoidance of the associated interest expense for the project.

Example 1
Interim Financing of Building Project Costs
Sale Premium Received

> Community A has a $25 million DPW project, with a construction schedule of two years. The voters have approved a Proposition 2½ debt exclusion for the bonds. To take advantage of favorable rates, Community A decides to issue $15 million bonds at the commencement of construction, with plans to issue the balance of the bonds as needed in the future. At the time of delivery of the bonds, Community A receives a sale premium on the bonds of $2 million, after paying issuance costs. At a subsequent town meeting, Community A votes to appropriate the $2 million to pay project costs and reduce the authorized borrowing for the project by the same amount. As a result, the total amount of bonds actually issued by Community A will not be greater than $23 million.

2. <u>Premium Applied at Sale</u>

Issuers of bonds or notes may reasonably expect that a significant premium will be offered for their bonds or notes at the time of sale. In these instances, a city, town or regional school district may reserve its right at the time of sale to reduce the size of its bond or note issue by the amount of the premium received from the purchaser of the bonds or notes. The city, town or regional school district then applies the premium, net of issuance costs paid from the premium, to pay costs of the project, reducing the overall amount to be borrowed accordingly and avoiding the associated interest expense. As in Section C-1 above, the city, town or regional school district must vote to appropriate the premium and reduce the borrowing authorization by the same amount.

Example 2
Interim Financing of Building Project Costs
Sale Premium Applied When Bonds or Notes Sold

> Community A has a $25 million DPW project, with a construction schedule of two years. The voters have approved a Proposition 2½ debt exclusion for the bonds. To take advantage of favorable rates, Community A decides to issue $15 million bonds at the commencement of construction. Anticipating that a

substantial premium will likely be received at the time of sale of the bonds, Community A reserves its right to reduce its bond issue size at the time the bonds are awarded, so as to reduce the bond issue by the amount of the premium received. The purchaser of Community A's bonds offers a premium of $2 million, net of issuance costs paid from the premium, on the $15 million issue. Community A reduces the issue by $2 million to $13 million, but still receives $15 million in proceeds. At a subsequent town meeting, Community A votes to appropriate the $2 million premium to pay project costs and reduce the authorized borrowing for the project by the same amount. As a result, Community A has $10 million that can still be borrowed to pay remaining project costs and it will not actually issue more than $23 million in bonds for the project.

3. Required Votes

The following language should be used for votes to appropriate bond premiums for project costs and reduce the authorized borrowing for the project.

If the bonds or notes sold were for more than one excluded borrowing, the portion of the premium allocable to each borrowing should be clearly identified in the vote, preferably by a separate vote for each borrowing.

a. Town Meeting Votes

Article: To see if the Town will vote to appropriate the premium paid to the Town upon the sale of bonds or notes issued for ______________ (purpose), which are the subject of a Proposition 2½ debt exclusion, to pay costs of the project being financed by such bonds or notes and to reduce the amount authorized to be borrowed for such project, but not yet issued by the Town, by the same amount, or to take any other action relative thereto.

Motion: That the Town appropriate $_______________ from the premium paid to the Town upon the sale of bonds or notes issued for _______________ (purpose), which are the subject of a Proposition 2½ debt exclusion, to pay costs of the project being financed by such bonds or notes and to reduce the amount authorized to be borrowed for such project, but not yet issued by the Town, by the same amount.

b. City/Town Council Orders

Ordered: That the City/Town appropriate $_______________ from the premium paid to the City/Town upon the sale of bonds or notes issued for _______________ (purpose), which are the subject of a Proposition 2½ debt exclusion, to pay costs of the project being financed by such bonds or notes and to reduce the amount authorized to be borrowed for such project, but not yet issued by the City/Town, by the same amount.

c. <u>Regional School Committee Votes</u>

Voted: That $________________ from the premium paid to the District upon the sale of bonds or notes issued for ________________ (purpose), which are the subject of Proposition 2½ debt exclusions approved in all member municipalities, be appropriated to pay costs of the project being financed by such bonds or notes and to reduce the amount authorized to be borrowed for such project, but not yet issued by the District, by the same amount.

DEBT SERVICE SCHEDULE EXAMPLE

Period Ending	Principal	Interest	Debt Service	Annual Debt Service
11/15/2002				
05/15/2003	$553,000	$414,702.50	$967,702.50	
06/30/2003				$967,702.50
11/15/2003		406,407.50	406,407.50	
05/15/2004	575,000	406,407.50	981,407.50	
06/30/2004				1,387,815.00
11/15/2004		397,782.50	397,782.50	
05/15/2005	605,000	397,782.50	1,002,782.50	
06/30/2005				1,400,565.00
11/15/2005		391,581.25	391,581.25	
05/15/2006	635,000	391,581.25	1,026,581.25	
06/30/2006				1,418,162.50
11/15/2006		382,850.00	382,850.00	
05/15/2007	665,000	382,850.00	1,047,850.00	
06/30/2007				1,430,700.00
11/15/2007		369,550.00	369,550.00	
05/15/2008	700,000	369,550.00	1,069,550.00	
06/30/2008				1,439,100.00
11/15/2008		355,550.00	355,550.00	
05/15/2009	735,000	355,550.00	1,090,550.00	
06/30/2009				1,446,100.00
11/15/2009		342,687.50	342,687.50	
05/15/2010	770,000	342,687.50	1,112,687.50	
06/30/2010				1,455,375.00
11/15/2010		328,250.00	328,250.00	
05/15/2011	810,000	328,250.00	1,138,250.00	
06/30/201 1				1,466,500.00
11/15/2011		312,050.00	312,050.00	
05/15/2012	850,000	312,050.00	1,162,050.00	
06/30/2012				1,474,100.00
11/15/2012		295,050.00	295,050.00	
05/15/2013	895,000	295,050.00	1,190,050.00	
06/30/2013				1,485,100.00
11/15/2013		271,556.25	271,556.25	
05/15/2014	940,000	271,556.25	1,211,556.25	
06/30/2014				1,483,112.50
11/15/2014		246,881.25	246,881.25	
05/15/2015	985,000	246,881.25	1,231,881.25	
06/30/2015				1,478,762.50
11/15/2015		221,025.00	221,025.00	
05/15/2016	1,035,000	221,025.00	1,256,025.00	
06/30/2016				1,477,050.00
11/15/2016		193,856.25	193,856.25	
05/15/2017	1,085,000	193,856.25	1,278,856.25	
06/30/2017				1,472,712.50
11/15/2017		165,375.00	165,375.00	
05/15/2018	1,140,000	165,375.00	1,305,375.00	
06/30/2018				1,470,750.00
11/15/2018		135,450.00	135,450.00	
05/15/2019	1,195,000	135,450.00	1,330,450.00	
06/30/2019				1,465,900.00
11/15/2019		104,081.25	104,081.25	
05/15/2020	1,255,000	104,081.25	1,359,081.25	
06/30/2020				1,463,162.50
11/15/2020		71,137.50	71,137.50	
05/15/2021	1,320,000	71,137.50	1,391,137.50	
06/30/2021				1,462,275.00
11/15/2021		36,487.50	36,487.50	
05/15/2022	1,390,000	36,487.50	1,426,487.50	1,462,975.00
06/30/2022				
TOTAL	**$18,138,000**	**$10,469,920.00**	**$28,607,920.00**	**$28,607,920.00**